

No. 6449

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**In the United States Circuit Court of  
Appeals for the Ninth Circuit** 21

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**H. STANLEY BENT, PETITIONER**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

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**ON PETITION TO REVIEW AN ORDER OF THE UNITED STATES  
BOARD OF TAX APPEALS**

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**BRIEF FOR RESPONDENT**

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**BRIEF FOR RESPONDENT**

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**PREVIOUS OPINION**

The only previous opinion in the present case is that of the Board of Tax Appeals (R. 125), which is reported in 19 B. T. A. 181.

**JURISDICTION**

The appeal is taken from a decision of the Board of Tax Appeals in respect of individual income and surtaxes for the year 1920 in the amount of \$60.50, final order of redetermination being entered on May 14, 1930, and from the decision of the Board of Tax Appeals that it had no jurisdiction over the year 1922, there being no deficiency asserted for

that year. (R. 135.) The case is brought to this court by a petition for review filed October 31, 1930 (R. 135), pursuant to the provisions of the Revenue Act of 1926, c. 27, Sections 1001, 1002, and 1003, 44 Stat. 9, 109, 110.

#### QUESTIONS PRESENTED

1. Under the evidence of record did the Board properly affirm the determination of the Commissioner that petitioner maintained his records and correctly reported income on a "long-term completed contract" basis?

2. Did the Board properly affirm the determination of the Commissioner where no evidence was adduced from which the tax liability could be determined on any basis other than that adopted by the Commissioner?

3. Did the Board err in dismissing the proceeding for 1922 for want of jurisdiction, the Commissioner's determination having been that there had been an overassessment of tax for that year?

#### STATUTES INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057:

SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with

the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. \* \* \*

SEC. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

\* \* \* \* \*

(d) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212

except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 273. As used in this title in respect of a tax imposed by this title the term "deficiency" means—

(1) The amount by which the tax imposed by this title exceeds the amount shown as the tax by the taxpayer upon his return; but the amount so shown on the return shall first be increased by the amounts previously assessed (or collected without assessment) as a deficiency, and decreased by the amounts previously abated, credited, refunded, or otherwise repaid in respect of such tax; \* \* \*.

SEC. 274. (a) If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this title, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within 60 days after such notice is mailed (not counting Sunday as the sixtieth day), the taxpayer may file a petition with the Board of Tax Appeals for a redetermination of the deficiency. \* \* \*

\* \* \* \* \*

(f) \* \* \* If the taxpayer is notified that, on account of a mathematical error appearing upon the face of the return, an amount of tax in excess of that shown upon the return is due, and that an assessment of



the tax has been or will be made on the basis of what would have been the correct amount of tax but for the mathematical error, such notice shall not be considered, for the purposes of this subdivision or of subdivision (a) of this section, or of subdivision (d) of section 284, as a notice of a deficiency, and the taxpayer shall have no right to file a petition with the Board based on such notice, nor shall such assessment or collection be prohibited by the provisions of subdivision (a) of this section.

**Treasury Regulations 45:**

ART. 36. *Long-term contracts.*—Persons engaged in contracting operations, who have uncompleted contracts, in some cases perhaps running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from such gross income should include and be limited to the expenditures made on account of such completed contracts. \* \* \*

**STATEMENT OF FACTS**

The essential facts as found by the Board of Tax Appeals are as follows (R. 126-131):

Petitioner, a citizen and resident of the state of California, was during 1920 a member of the firm

of Bent Brothers, a partnership composed of himself and Arthur S. Bent. The partnership is engaged in the construction under contracts of dams, reservoirs, canals, and similar projects. Frequently such projects are not completed within the same taxable year in which the work is begun.

The method of accounting regularly employed in keeping the partnership's books, from the inception of the business in 1910 until the partnership was succeeded by a corporation in 1923, was as follows: A separate account was kept in the partnership books for each project undertaken. At the end of the month this account was charged with the cost, whether paid or not, of all labor, materials, and direct expenses incurred during the month and chargeable to the project. At the close of the year the account was charged with its proportion of the indirect expenses, or overhead, of the business incurred during the year, whether paid or not. The overhead was distributed over the several projects upon which work had been performed during the year in the same proportions that the total costs of each project incurred during the year bore to the total costs of all projects incurred during the year. If the contract provided for payment upon completion of the project the customer's account was charged and the separate account of the project was credited when all work was completed and accepted. If payment was to be made as the work progressed, upon the basis of monthly estimates by the customer's engineer of

work completed during the month and the amount of payment due therefor, the customer's account was charged, and the separate account of the project was credited, as such estimates were received, with the amount of payment shown to be due by the estimate. If the contract provided that a percentage of the amount due on each estimate was to be withheld pending completion and acceptance of the project, the separate account of the project was credited only with the payment due and the amount of the holdback was credited to "Retention Account." No accounting was made for any gain or loss on any project until the work was completed and accepted. Until that time the debit balance in a project account was considered an investment and carried on the books as an asset. When work was completed and the project accepted, the project account was closed by transferring the balance representing gain or loss to profit and loss account.

The net income reported by the partnership in all returns filed for Federal income-tax purposes was computed in accordance with the method of accounting employed in keeping the books.

During 1920 the partnership was engaged on four projects which were not completed in the same taxable year in which work was begun. Devil's Gate Dam was commenced in 1919 and completed in 1920; work on Huntington Park Reservoir began in 1920 and was completed in 1921; work on Rodeo Drain started in 1920 and was completed in 1921;

and work on San Dimas Dam began in 1920 and was completed in 1922.

Devil's Gate Dam was constructed within the Los Angeles County Flood Control District. This contract provided that compensation should be paid to the partnership upon the basis of monthly estimates of materials furnished and work completed. Compensation shown to be due by the monthly estimates of the chief engineer of the Flood Control District were usually paid by the tenth of the following month.

In accordance with the method of accounting employed in keeping the books, the partnership included in the return for 1920 the entire compensation received for and all of the costs and expenses incident to the construction of Devil's Gate Dam which was completed in that year, but did not include the income or expenses relating to the three other projects commenced but not completed in that year. It was the partnership's custom to report income from each job when it was completed.

Upon auditing the returns of the petitioner, the respondent determined a deficiency for 1920 and overassessments for 1919, 1921, and 1922, all of which was communicated to the taxpayer in the usual form of notice for the deficiency. The petitioner's contention was that his income should have been computed each year on the accrual basis entirely without regard to the partnership's method of treatment of the long-term contracts, and that the Commissioner was in error in his de-

termination that the books of the partnership were kept on the completed long-term contract basis and so considered reflected net income according to a recognized method. The Board of Tax Appeals found as a fact that the books of the partnership were maintained on the completed long-term contract basis, and that the method of recording and reporting income had been followed from 1913 to 1922, and that such method was in accordance with Section 212 of the Revenue Act of 1918 and accurately reflected income. (R. 132, 133.)

The Board of Tax Appeals also held that inasmuch as the Commissioner had determined an over-assessment for the year 1922, as to that year it was without jurisdiction. The Board further found, in regard to the insufficiency of the evidence adduced by the petitioner to sustain his contentions as the method which should have been adopted (R. 134), that—

\* \* \* since the deficiency has been determined by this method and petitioner has not established what in fact was the income resulting from the method he suggests with the consequent tax liability, the deficiency could not be set aside on the record in any event.

The Board accordingly affirmed the determination of the Commissioner and entered its final order that there was a deficiency of \$60.50 for the year 1920. From this decision this case is brought to this court.

## SUMMARY OF ARGUMENT

The record supports the finding of fact by the Board that the books were maintained upon a completed contract basis. Such basis clearly reflected income and such basis was consistently used in the reporting of income for Federal tax purposes and was therefore proper in this case.

There was no evidence adduced to prove that the books were kept on any basis other than that which was adopted by the Commissioner to ascertain the amount of income. Accordingly the Board properly affirmed the determination of the Commissioner.

The proceeding with respect to the year 1922 was properly dismissed by the Board for want of jurisdiction, no deficiency for that year having been determined by the Commissioner.

## ARGUMENT

## I

**The record supports the finding of fact by the Board that the books were maintained upon a completed contract basis. Such basis clearly reflected income and such basis was consistently used in the reporting of income for Federal tax purposes and was therefore proper in this case**

The Board of Tax Appeals found that the partnership kept its books on the long-term completed contract basis and therefore determined the petitioner's tax for 1920 in accordance with the provisions of Article 36 of Regulations 45. The peti-

tioner is liable in his individual capacity for his distributive share of the net income of the partnership. (Sec. 218 (a), Revenue Act of 1918.) We respectfully submit that the decision of the Board was in exact accordance with the law.

Section 212 (a) and (b) of the Revenue Act of 1918 provides that net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. Article 36 of Regulations 45, promulgated under Section 212, *supra*, provides:

Persons engaged in contracting operations who have uncompleted contracts \* \* \* will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from such gross income should include and be limited to the expenditures made on account of such completed contracts. \* \* \*

The provisions of Section 212, *supra*, have been reenacted without change in the corresponding section of the Revenue Act of 1921, c. 136, 42 Stat. 227; Revenue Act of 1924, c. 234, 43 Stat. 253; Revenue Act of 1926, c. 27, 44 Stat. 9; and Revenue Act of 1928, c. 852, 45 Stat. 791, which comprise all the revenue laws enacted since that time. This con-

sistent reenactment by Congress, in view of this interpretation of the methods to be employed in arriving at net income made by those charged with the administration of the revenue laws, gives it as full effect as though it were part of the statute itself. *Heiner v. Colonial Trust Co.*, 275 U. S. 232; *Brewster v. Gage*, 280 U. S. 327; *United States v. Jackson*, 280 U. S. 183; *Uniform Printing & S. Co. v. Commissioner* (C. C. A. 7th), 33 F. (2d) 445; *Fidelity Nat. Bank & T. Co. v. Commissioner* (C. C. A. 8th), 39 F. (2d) 58; *Marsh Fork Coal Co. v. Lucas* (C. C. A. 4th), 42 F. (2d) 83.

It is readily apparent, therefore, that one keeping books upon the basis above described must under the law report his income on that basis. The Board specifically found (R. 133) that the partnership's and petitioner's returns were properly made on the long-term completed contract basis and that this was in accordance with the accounting method regularly employed, and that the Commissioner was fully justified in adopting that method in auditing the return. This finding of fact with respect to the method of keeping the partnership's books finds ample support in the record. The general procedure adopted was to file at the end of each month the engineer's estimate as to the amount of work done and compensation due under each contract. (R. 175-176.) This practice was followed in connection with each contract and the general cost was put on the books monthly and at the end of the year a portion of the overhead was put into



each job to give the full cost of the job for the year. (R. 178.) The cash received was entered on the books but nothing else was done with it until the end of the job. (R. 180.) The books were not closed on these several jobs at the close of the year and the returns made accordingly because it had not been the custom. (R. 183.) The expense which was credited to the jobs was not charged to profit and loss at the end of the year but was withheld until the job was completed. (R. 185.) This method of bookkeeping had been consistently followed from 1912 through 1922. (R. 185.) The returns had been made consistently upon a completed contract basis irrespective of the annual period. *The profit and loss account never reflected the earnings for the year until the job was completed.* (R. 187-188.) Wilbur Atkinson, in charge of the records of the partnership, testified as follows (R. 189):

We did not at that time carry income on uncompleted contracts into profit and loss account until they were completed; when they were, then we showed them on our returns. Our returns at that time should have conformed to the loss and gain account, but not to the job accounts. *Until we closed our job account we did not show any loss and gain.* (Italics ours.)

The petitioner herein testified (R. 191) that jobs which carried over from one year to another were not analyzed at the end of the year except for the personal information of the managers. He testified

that the amount invested in each job was ignored when they came to figure the profit and loss at the end of the year. (R. 193.) The partnership treated the money invested in an uncompleted job at the end of the year as money invested in a savings bank or any other depository. The general books of the taxpayer during the year under review reflected only completed jobs. (R. 195.)

In the face of this consistent testimony, we submit that there is ample evidence to support the finding of fact by the Board of Tax Appeals that the accounting records of the partnership and the petitioner were maintained upon a completed contract basis. This finding of fact supported by substantial evidence can not properly be disturbed by this court upon review. *American Sav. Bank & Trust Co. v. Burnet* (C. C. A., 9th), 45 F. (2d) 548. (See also the numerous cases therein cited by this court.)

In the petitioner's brief stress is laid upon the statement that the books of the partnership and petitioner were maintained upon an accrual basis and the conclusion is drawn from this fact that a completed contract basis was therefore not adopted. Not only is this not established by proof, but it can not be said in any event that the books, as far as the separate job accounts are concerned, were on the accrual basis. The accrual method of accounting requires that at the end of each accounting period all income which has been earned during the period must be accounted for as income accrued

in that period. *Allhands v. Crooks*, U. S. D. C. W. D. Mo. (not yet reported but to be found in C. C. H. Federal Tax Service, Volume III, at par. 9057). Not only were accounting periods disregarded while the separate jobs remained uncompleted, but the general books of the partnership did not show all the income accrued in any given year. The job accounts were taken into consideration only when the particular contract was completed within that accounting period. However, for the sake of argument, admitting that the general books of the partnership were maintained on an accrual basis, we submit that there is nothing inconsistent with the adoption of an accrual basis of accounting for the general books and the treatment of records according to the completed contract method at the same time. The accrual basis as defined by the Supreme Court in *United States v. American Can Co.*, 280 U. S. 412, is that "basis where pecuniary obligations payable to or by the company were treated as if discharged when incurred." In a manner entirely consonant with this method of keeping records the rights to receive compensation predicated upon the engineer's monthly estimates were entered upon the books as the work progressed.

The recognition of obligation or rights coming into existence in advance of discharge or realization by cash transaction is the sum and substance of what is embraced in the accrual basis as distinguished from cash receipts basis of accounting.

The completed contract method merely permits a further plan or basis of maintaining records to be recognized for tax purposes. It sanctions the charging of the obligations and rights when incurred upon the books, not to the general profit and loss accounts, but to the separate job accounts and permits each job or contract account to remain open for profit and loss determination until that particular job or contract has been completed. Thus in the case of *Grays Harbor Motorship Corporation v. United States*, 45 F. (2d) 259, the Court of Claims noted in its findings of fact that "the plaintiff kept its books of account on the accrual basis" and then continued to point out that it had failed to keep its records on the completed contract basis but had reported its income as earned without reference to the completion date of the contract. In the case of *Harrison v. Heiner*, 28 F. (2d) 985, the District Court for the Western District of Pennsylvania found as a fact that the plaintiff kept its books and filed its return on the accrual basis and also that its method of accounting and method of reporting income for Federal tax purposes was to include the total amount from each contract in the year in which the contract was finished. In this case the completed contract basis of accounting was approved. It is thus apparent that there is no inconsistency when books are kept on the accrual basis and the completed contract method used at the same time, and that a computation of income on the accrual basis of accounting

can readily be made on either the "completed contract" or "percentage of profit upon partial completion" basis at the option of the taxpayer as provided in Article 36, Regulations 45.

*When the completed contract method is used in cases where the taxpayer is on the accrual system of accounting the only variation from the regular course of treatment is that the accruals in each job account are recognized for the first time when that particular contract is completed.*

The petitioner in his brief urges that the only type of long-term contracts which may properly afford a basis for the reporting of income upon the completed contract basis are those contracts which he designates as lump-sum contracts. He contends that *only* in that type of contract is the determination of the correct income realized upon the contract at any given time prior to completion difficult or impracticable. It appears, however, that the same difficulty or impracticability is encountered where the payment is *not* on the lump-sum plan. We submit that there is never an assurance that costs of operation will remain at a constant level; that items of expense may not occur in one period and be properly allocable over an entire project covered by the long-term lump-sum contract, or some other condition arise which would make a completed contract basis of accounting the more accurate method of reflecting income than any other basis. As a practical matter, profit or loss can never be absolutely determined in any case until per-

formance has been completed on the entire contract in accordance with the terms thereof. It is not until the contract has been completed by the contractor that he has earned the full consideration for which he contracted. It is therefore apparent that in the choice of methods of treating long-term contracts the completed contract basis is the one which is most apt to correctly reflect the income of the taxpayer. It is further apparent that there is no distinction regarding these considerations between the lump-sum type of payment or the per unit of completion type. No distinction can be maintained when based merely upon the payment plan of a given contract.

The Regulations allow long-term contracts to be treated in two ways; on the basis of completed work (in which case there is no question as to the profit earned) and on the estimated percentage of profit made during the year based upon the amount of expenses incurred during the said year. In the latter case, if it later develops that the estimate was erroneous, an amended return must be filed to show the correct income. That the first method mentioned is more apt to reflect true net income in accordance with the Statute is manifest.

The argument of the taxpayer and case cited to support the contention (Br. 29, 30, 31, 32) that if it be conceded that the books were not kept on the accrual basis they did not correctly reflect the annual income is of little value in view of the fact that, not only does the government maintain that

there is nothing in the acceptance of the completed contract basis which precludes the method of keeping books on the accrual system but the petitioner here was consistent throughout in the treatment of the long-term contracts. This in itself distinguishes the instant case from the case cited by the petitioner and is in no way identical with it as he states. The case in question, *Owen-Ames Kimball Co.*, 5 B. T. A. 921, cited by petitioner on page thirty of his brief, manifests the difference when it states (pp. 30-31):

Income from long-term contracts \* \* \* was accounted for on petitioner's books in an entirely inconsistent manner. There existed no uniform practice as to the time and manner of accounting for income from that source. This income was accounted for at the caprice of the bookkeeper, at irregular periods, and in amounts which were not determined upon any definite or reasonable basis.

In view of the foregoing, it is submitted that the Board properly found that the petitioner and the partnership maintained their records on the completed contract basis; that this basis was sanctioned by the Revenue Act and had been consistently adopted by the taxpayer in the reporting of taxable income from 1913 through 1922. The Board of Tax Appeals therefore properly affirmed the Commissioner's determination of taxable income upon this basis.

## II

**There was no evidence adduced from which the amount of income could be ascertained upon any basis other than that adopted by the Commissioner. Accordingly, the Board properly affirmed the determination of the Commissioner**

The foregoing consideration of this case has been directed to the propriety of the Commissioner's determination from the standpoint of correct application of law, and has, we submit, established that the Board properly affirmed the Commissioner's determination. We further submit, however, that regardless of that phase of the case, the decision of the Board on the record herein may not be disturbed.

The findings of the Commissioner are prima facie correct and the taxpayer who complains of them before the Board of Tax Appeals has the burden of showing that they are wrong. *Wickwire v. Reinecke*, 275 U. S. 101; *Am-Plus Storage B. Co. v. Commissioner* (C. C. A., 7th), 35 F. (2d) 167; *Botany Mills v. United States*, 278 U. S. 282. The taxpayer failed to sustain this burden on the record in the instant case.

Moreover, the taxpayer has not established what in fact was the income resulting from the method which he suggests and its consequent tax liability. His failure to produce competent and persuasive proof upon which an intelligent assessment may be predicated is fatal to his case. *Lucas v. Structural Steel Co.*, 281 U. S. 264; *Burnet v. Houston*,



283 U. S. 223; *F. G., Inc., v. Commissioner* (C. C. A. 7th), 47 F. (2d) 541; *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359.

### III

**The proceeding with respect to the year 1922 was properly dismissed by the Board for want of jurisdiction, no deficiency for that year having been determined by the Commissioner**

The Board of Tax Appeals was created to review determinations of *deficiency* by the Commissioner of Internal Revenue and afford administrative relief from such determinations in the ordinary type of case before assessment and collection of the additional taxes so proposed. *Oesterlein Machine Co.*, 1 B. T. A. 159. The statutory provisions, particularly Sections 273 (1) and 274 of the Revenue Act of 1926, define those determinations of deficiency which constitute the subject matter over which the review by the Board of Tax Appeals is authorized. Thus in the first instance the jurisdiction of the Board is limited to determinations of a *deficiency* in respect of tax. In turn by Section 273 (1) the term "deficiency" is defined to be:

The amount by which the tax imposed by this title exceeds the amount shown as the tax by the taxpayer upon his return; \* \* \*.

In the instant case the sixty-day letter from which the petition was filed with the Board of Tax Appeals notified the petitioner of an overassessment for the year 1922 of \$671.02. (R. 17, 19.) And the

statement contained in the letter was that "the overassessment shown herein will be made the subject of certificates of overassessment which will reach you in due course through the office of the Collector of Internal Revenue for your district." (R. 20.) There was in this determination of the Commissioner and notification to the taxpayer no indication of an amount by which "the tax exceeded the amount shown upon the return," but on the contrary a disclosure of an amount by which that shown on the taxpayer's return exceeded the tax properly due. There was therefore no determination of *deficiency*, and the Board of Tax Appeals properly dismissed the proceedings in so far as they purported to relate to the year 1922. *R. P. Hazzard Co.*, 4 B. T. A. 150; *Cornelius Cotton Mills*, 4 B. T. A. 255.

In the brief of the petitioner, computations are indicated in support of the proposition that there was in fact a mathematical error on the return so that the total tax liability shown thereon was overstated in the sum of \$1,440. No tax was yet paid by the taxpayer and he urges that this sum had been abated before the representative of the bureau discovered the erroneous deduction resulting in that year from the use of an incorrect basis for computing the income from long-term contracts. We submit, however, that the thing on which a deficiency is predicated is the correct net income of the taxpayer computed according to the statute. It is upon this that the tax imposed by the statute is

computed. Until the latter is ascertained, no "deficiency" can be determined. (See Sec. 273 and 274, Revenue Act of 1926.) It is incumbent upon the Commissioner therefore to stop at nothing short of determining the proper tax on the true net income, and to do this he must take all items which influence the computation of the correct tax into consideration. See *Levy v. Commissioner* (C. C. A. 9th), 48 F. (2d) 725; *Lewis v. Reynolds* (C. C. A. 10th), 48 F. (2d) 515.

#### CONCLUSION

In view of the foregoing, it is submitted that the decision of the Board of Tax Appeals should be affirmed.

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OCTOBER, 1931.